The Selling of the Flat Tax: The Dubious Link Between Rate and Base

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I. INTRODUCTION

There may yet be a flat tax in your future. Although the flat tax issue did not carry Steve Forbes to the White House,[1] there is still strong support—among politicians and among the public—for radical tax reform. Recent opinion polling indicates almost no one thinks the current income tax is "basically fine,"[2] and in two recent polls the flat tax has defeated the income tax by a margin of two-to-one.[3] Republican politicians are pushing the issue in various ways. On June 17, 1998, the House of Representatives passed the "Tax Code Termination Act," which would scrap the Internal Revenue Code on December 31, 2002.[4] Although the bill does not specify the details of the replacement tax, it does indicate that the replacement should not be progressive and should be imposed on a consumption base.[5] In 1997, Representatives Dick Armey and Billy Tauzin embarked on a national debate tour; they agreed that the income tax should be scrapped, but Armey would replace

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1 *See* Ernest Tollerson, *Bowing Out: Forbes Quits and Offers His Support to Dole*, N.Y. TIMES, Mar. 15, 1996, at A26 (summarizing Forbes' presidential campaign).

2 *See* Susan Page & William M. Welch, *Things-to-do 1998: Tax Reform Tops List*, USA TODAY, Dec. 22, 1997, at A1 (reporting results of USA Today/CNN/Gallup Poll, that 5% of those surveyed consider the current system "basically fine," and 95% want change).

3 *See NBC News/Wall Street Journal Poll*, survey ending Oct. 28, 1997, *available in* Nexis RPOLL file, accession number 0291157 (asked their opinion of replacing the income tax with a flat tax (at 17%), 61% were in favor and 32% opposed); Ann Reilly Dowd, *Get the Facts on Tax Reform*, MONEY, Jan. 1998, at 86 (reporting result of Nov. 1997 Money/ICR Research poll, in which two out of three respondents favored Dick Armey's version of the flat tax).

4 *See* Ryan J. Donmoyer, *In Election Year Gambit, House Votes to Scrap Code*, 79 TAX NOTES 1533 (1998); H.R. 3097, 105th Cong. (1998) (Rep. Largent). The House-passed bill was referred to the Senate Finance Committee on June 18, 1998. 144 CONG. REC. S6563 (daily ed. June 18, 1998). It languished there until the end of the legislative session.

5 H.R. 3097, 105th Cong. §§ 3(a)(1) (the replacement tax system should "appl[y] a low rate to all Americans"), 3(a)(4) (the new system should "eliminate[] the bias against savings and investment") (1998).

it with the flat tax, Tauzin with a national sales tax.[6] Republicans are committed to making fundamental tax reform a key issue in the 2000 elections.[7]

Two recent developments have shortened the life expectancy of the income tax. The 1997 Senate Finance Committee hearings on Internal Revenue Service abuses generated a tremendous public response, and hostility toward the IRS readily translates into hostility toward the Internal Revenue Code.[8] The prospect of budget surpluses may be even more significant. If tax reform must be revenue neutral, there will inevitably be taxpayers who will pay more under the new system, and who will therefore oppose reform. Budget surpluses remove the revenue neutrality constraint, making it possible to compensate those who would otherwise be losers under tax reform.[9] It may now be possible to buy off the opposition.[10]

Although there are several candidates for successor to the income tax, the most prominent is the "flat tax," designed by economists Robert E. Hall and Alvin Rabushka,[11] and championed by Dick Armey[12] and Steve Forbes.[13] The naming of the proposal

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6 *See* Dick Armey & Billy Tauzin, *Flat Tax or Sales Tax, A New System Should Have a Single Rate and Shouldn't Favor Any One Type of Income*, L.A. TIMES, Oct. 5, 1997, at M5 (announcing the "Scrap the Code Tour").

7 *See* John Machacek, *Paxon, Oklahoman Offer Bill Setting Deadline for Abolition of Tax Code*, GANNETT NEWS SERVICE, Jan. 22, 1998 (*available in* Nexis CURNWS file) (Representative Bill Paxon predicts fundamental tax reform will be a major issue in the 2000 presidential election); Jonathan Chait, *The Flat Tax Scam*, NEW REPUBLIC, Dec. 15, 1997, at 23 ("Republicans intend for this new campaign to build through the 1998 or 2000 elections and culminate in the abolition of the progressive income tax"). As two leading tax economists have noted, "The odds are that we're in for a tremendous battle over our tax system . . . at some time in the near future." JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES 14 (1996).

8 *See* Ronald Brownstein, *GOP Lawmakers Are Counting on Making Taxes Pay in 1998 Agenda*, L.A . TIMES, Dec. 1, 1997, at A5 ("Republicans sensed renewed opportunity in taxes this fall after the spectacular public response to the Senate Finance Committee hearings on Internal Revenue Service abuses"). Alvin Rabushka, co-inventor of the flat tax, recently described attacking the IRS as "a strategy that helps sell the [flat tax] issue." Ryan J. Donmeyer, *Flat Tax Strategy: The IRS as Poster Boy for Tax Reform*, 77 TAX NOTES 1305 (1997). Conservative economist Lawrence Kudlow agreed that flat tax proponents should "use the IRS abuses as a launching pad." *Id.*

9 *See* Dean Foust, *The Partisan Battles Are on Their Way Back*, BUSINESS WEEK, Dec. 29, 1997, at 80 (quoting an unnamed White House advisor, that "[t]he big political change [in tax reform] is that you can think about buying off the losers with the surplus").

10 A third development may also bode ill for the income tax. Although the Taxpayer Relief Act of 1997 (Pub. L. No. 105-34, 111 Stat. 788 (1997)) appears to be a step away from fundamental tax reform, some reformers see it as the beginning of the end for the income tax. In their view, the complexity added by the new law "will sow the seeds of the income tax code's final destruction." *Simple, No?*, ALL THINGS CONSIDERED Transcript # 97080511-212, Aug. 5, 1997 (*available in* Nexis NPR file) (reporting opinion of Rep. Tauzin).

11 ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 1995) [hereinafter FLAT TAX I].

12 Freedom and Fairness Restoration Act of 1995, H.R. 2060 and S. 1050, 104th Cong. (1995) (sponsored by Rep. Armey and Sens. Shelby, Craig and Helms).

13 A poll taken in late 1997 asked respondents to choose between the current tax system and the flat tax, and between the current system and a national retail sales tax. The

makes it a curiousity among taxes. Every other tax—income, sales, property, estate, gift, value-added—is named after what it taxes. Only the flat tax is named after its rate structure, with no hint as to *what* it might be flatly taxing.[14] This approach is not an accident. Diverting attention from base to rate is good strategy. The idea of a single rate of tax has considerable appeal to the American public, but a consumption tax base may be difficult or impossible to sell on its own. This is especially true of the flat tax's version of a consumption base, under which individuals pay tax on wage income but not on investment income.

It is clear why flat taxers believe there is political advantage to linking a consumption base to a flat rate, and to downplaying base while emphasizing rate. If one wants to sell a move to an unpopular tax base, the best approach might be to link the base to a popular flat rate. But is there any justification beyond politics for the linkage? As a technical matter, the consumption base and flat rate features of the flat tax are completely separable.[15] There is no technical barrier to either a flat income tax or a progressive consumption tax. If the linkage is justified, it must be because there is some logical or philosophical reason why support for a flat tax implies support for a consumption base.

This article examines the politics and the merits of the case for linkage. It begins with a brief explanation of the Hall-Rabushka-Forbes-Armey flat tax, placing it in the context of other (less prominent) proposals for replacing the income tax with a consumption tax. It next examines the politics of presenting the flat tax's base and rate as a package. The Article then turns to the merits of the link. It considers the argument that an overriding concern for efficiency dictates both a consumption base and a flat rate, a similar argument that an overriding concern for simplicity dictates both the base and the rate, and more technical arguments that certain desirable forms of tax neutrality—between present and future consumption, and among persons with different lifetime earnings patterns—can be achieved only with a flat rate consumption tax. The conclusion is that there is no persuasive case

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flat tax beat the current system by almost two-to-one (61% to 32%), but the retail sales tax barely edged out the current system (47% to 43%). *NBC News/Wall Street Journal Poll*, survey ending Oct. 28, 1997, *available in* Nexis RPOLL file, accession numbers 0291157 (flat tax) and 0291158 (sales tax).

14 In fact, it is taxing consumption.

15 The flat tax also involves a third innovation, the elimination of personal deductions, which is also fully separable as a technical matter from the other two changes. However, the separability of the deduction issue is widely understood, while the separability of the base and rate issues is not. *See, e.g.*, The National Commission on Economic Growth and Tax Reform, *Unleashing America's Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century*, *reprinted in* 70 TAX NOTES 413, 424-26 (1996) [hereinafter Kemp Commission] (insisting that tax reform must include both a consumption base and a single rate of tax, but agnostic as to whether the home mortgage interest deduction should be retained).

for linking the base and rate issues, and that a well-informed public debate on tax reform requires that each issue be discussed on its own merits. The likely result of uncoupling the two issues will be a public rejection of a consumption tax base, at least in its flat tax form.

II. The Flat Tax and other Consumption Tax Proposals

A. The Many Faces of Consumption Taxation

Under a comprehensive income tax, income is subject to tax whether it is consumed or saved. Under a consumption tax, only consumed income is subject to tax. The actual United States "income" tax occupies a middle ground between a pure income tax and a pure consumption tax. There is no general exemption for saved income, but there are important instances in which saved income is not taxable—two of the most prominent being the deferral of tax on unrealized appreciation and the deferral of tax on qualified retirement savings.[16]

A consumption tax can take many forms. Recent proposals to replace the income tax have advocated four forms of consumption taxes with very different appearances, despite their underlying kinship.[17]

The USA (Unlimited Savings Allowance) Tax, proposed by Senators Nunn, Kerrey, and Domenici, most closely resembles the income tax.[18] As a "cash flow" version of a consumption tax, it computes its tax base in the same manner as an income tax, except that it allows a deduction for all saved income (and taxes all spending out of savings).[19] Since income must be either consumed or saved, when savings are deducted from income what remains as the tax base is necessarily consumption. The USA Tax is unique among recent major consumption tax proposals in that it is not flat—its marginal rates range from 19% to 40%.[20] The relatively high marginal rates may explain the failure of the USA Tax to generate great interest with either Congress or the public.

It is possible to tax consumption without involving individuals directly in the process. In theory, at least, a broad-based retail sales tax (RST) would have the same aggregate tax base as a cash

16 I.R.C. §§ 1001(a) (taxable gains with respect to property occur only upon a "sale or other disposition" of the property), 219 (individual retirement accounts), 401-420 (tax-favored employer-provided pensions and individual retirement accounts) (1994 & Supp. III 1997).

17 *See* Slemrod & Bakija, *supra* note 7, at 196 ("Since these four alternatives appear on the surface to be very different, their essential similarity is often completely misunderstood.").

18 USA Tax Act of 1995, S. 722, 104th Cong. (1995).

19 *Id.* § 50.

20 *Id.* § 1.

flow individual-based consumption tax, without requiring individuals to file tax returns. A national RST has been proposed as a replacement for the income tax, and has been mentioned approvingly by Ways and Means Chairman Bill Archer.[21] A value-added tax (VAT) resembles an RST, except that a portion of the tax is collected at each stage of the production process, instead of the entire tax being collected at the point of retail sale. In a subtraction method VAT, a business would pay the tax on its total sales, reduced by deductions for purchases of inputs from other firms, and for purchases of plant and equipment.[22] By the time the sale to the consumer is complete, the value subject to tax is the same amount that would be taxed at the cash register under an RST. Chairman Archer has also expressed interest in replacing the income tax with a VAT.[23]

Because neither individuals nor families are taxable units under an RST or a VAT, those taxes cannot be imposed at a higher rate on the consumption of more affluent persons or households. For this technical reason, an RST or a VAT—unlike an income tax or cash flow consumption tax—must be flat.

The flat tax of Hall, Rabushka, Forbes, and Armey is a variation on a VAT. The flat tax splits the VAT into a two-part tax base. The business tax portion is the same as the tax base of a VAT, except that it also allows a deduction for wages and salaries paid.[24] The wages deducted from the business tax are included in the wage tax portion of the flat tax.[25] Since the same flat rate (19% in the Hall-Rabushka version) applies to both the business tax and the wage tax, at first the bifurcation of the VAT base seems pointless. Why remove wages from the base of one 19% tax, only to tax them at the same 19% rate under another tax?

Actually, the bifurcation serves an important function—exempting subsistence wages from tax. In the Hall-Rabushka proposal, the tax-free allowance for wages is $16,500 for a married couple, $9500 for a single person, and $14,000 for a single head of household, with an additional $4500 for each dependent.[26] A married couple with two children, for example, could earn $25,500 free of the wage tax. To Hall and Rabushka, the complication of a bifurcated tax base is justified by two effects of the exemption

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21 *See* Stephen Moore, *The Economic and Civil Liberties Case for a National Sales Tax*, 71 TAX NOTES 101 (1996); Dan Balz, *Lugar Calls for a National Sales Tax to Replace Federal Levy on Income*, WASH. POST, Apr. 6, 1995, at A9; Clay Chandler, *Archer Calls for End to Income-Based Tax*, WASH. POST, June 6, 1995, at D1 (Archer undecided between national sales tax and some combination of sales tax and VAT).

22 *See* CHARLES E. MCLURE, JR., THE VALUE-ADDED TAX 89 (1987).

23 *See* Chandler, *supra* note 21.

24 *See* FLAT TAX I, *supra* note 11, at 55-57.

25 *See id.*

26 *Id.* at 59, 144. All allowances would be indexed for inflation.

levels—the insulation of poor wage earners from tax, and the average rate progressivity produced by putting a flat rate on top of a zero bracket (wages sheltered by the exemption being taxed at a zero rate).[27] Although bifurcation of the tax base would make graduated rates on wages technically feasible, the flat wage tax—in keeping with its name—has only a single rate above the tax-free allowances.

B. The Flat Tax, Consumption Taxes, and Wage Taxes

There is a close resemblance between the effects produced by a consumption tax and the effects of a stand-alone wage tax (as opposed to the wage tax of the flat tax, which is only part of the total tax base). Suppose a taxpayer has $10,000 in wages, which he intends to invest at 10% for one year, in anticipation of a consumption binge next year. The tax system is a flat 20% cash flow tax. Because amounts saved are not subject to tax, he can invest the entire $10,000. After one year, the savings will have grown to $11,000. After paying a tax of $2200,[28] he can consume $8800. If the tax system is, instead, a 20% flat wage tax, he will owe $2000 tax in the first year, and will be able to invest $8000 at 10%. The $800 investment income is tax-free under the wage tax, so he can consume $8800 next year—the same result as under the cash flow tax.

There are several caveats to the equivalency between a cash flow tax and a wage tax. For the equivalency to hold, the tax rate must remain constant, and the rate of return on the $8000 investment under the wage tax must be the same as the pre-tax rate of return on the $10,000 investment under the cash flow tax.[29] Most significantly, the equivalency holds only if there is no existing wealth (old capital) at the time the tax system is introduced.[30] A wage tax imposes no burden on existing wealth; the wealth may generate income free of tax, and it may be consumed free of tax. A cash flow tax, by contrast, does impact wealth in existence at the time of enactment. Consumption of that wealth—and of income generated by that wealth—will be subject to tax.

How does the flat tax fit into this analysis? Because it has a wage tax portion, which is much more visible than the business tax portion, the flat tax is easily misunderstood as a wage tax.

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27 *Id.* at 89, 123 (exempting the poor from the wage tax), 55 (average rate progressivity). As I have explained elsewhere, essentially the same results could be obtained with a value-added tax combined with universal cash rebates equal to the tax on subsistence consumption. Lawrence Zelenak, *Flat Tax vs. VAT: Progressivity and Family Allowances*, 69 TAX NOTES 1129 (1995).

28 Twenty percent of $11,000; the tax base is tax-inclusive.

29 *See* Michael J. Graetz, *Expenditure Tax Design*, *in* WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 161, 172-73 (Joseph A. Pechman ed., 1980).

30 *See id.* at 172.

Considering both parts of the tax together, however, it is a consumption tax, and as a consumption tax it imposes a burden on old capital. Although the expensing of post-enactment investment is the equivalent of exempting from tax the return on that investment,[31] the business tax *does* impose a burden on the return on old capital.[32] In other words, the flat tax amounts to a wage tax plus a tax on old capital. The burden on old capital could be lessened or even eliminated by special transition relief, but Hall and Rabushka would prefer, with perhaps too little regard for political reality, no transition relief.[33]

III. POLITICS: THE SELLING OF THE FLAT TAX

A. Hiding the Base Behind the Rate

Despite the tradition of naming a tax after its base, Hall and Rabushka have chosen to name their tax after its rate structure.[34] The name has succeeded, in the sense that public debate on the proposal has paid more attention to the question of rate structure than to the question of tax base design. That result is ironic because their proposed tax base is more innovative than their proposed flat rate.[35] Ironic though it may be, the diversion of attention from base to rate is good politics. Flatness is popular; exempting investment income from tax is not.

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31 More precisely, it is the equivalent of exempting the normal (risk-free) rate of return on investment. It is not the equivalent of exempting economic rent, monopoly profits, compensation for risk-taking, and rewards for entrepreneurial effort. *See* Richard Musgrave, *Clarifying Tax Reform*, 70 TAX NOTES 731, 735 (1996).

32 *See* SLEMROD & BAKIJA, *supra* note 7, at 205 (the business component of the flat tax makes the system a consumption tax, not a wage tax).

33 FLAT TAX I, *supra* note 11, at 78-79. They are open to the possibility of allowing businesses to continue to take depreciation deductions to which they would have been entitled if the income tax had not been replaced. If businesses were allowed to expense all income tax basis in business assets, in the year in which the flat tax became effective, that would completely remove the tax burden on existing capital. In that case, however, a wage tax would more simply accomplish the same economic effects as the bifurcated tax with complete transition relief for old capital. *See* SLEMROD & BAKIJA, *supra* note 7, at 175 ("the more transition relief that is provided to existing assets in the switch to any consumption tax, the more it becomes like a wage tax").

34 Slemrod and Bakija suggest that a consumption tax base can be considered flat because it "imposes a uniform, call it flat if you like, tax on current consumption and future consumption." SLEMROD & BAKIJA, *supra* note 7, at 167. They concede, however, that a consumption base "is not commonly associated (by noneconomists) with flatness." *Id.*

35 *See* DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 76 (1986) [hereinafter BRADFORD I] (noting, during the early years of the discussion of the flat tax, that "[t]he quality of flatness seems to be principally responsible for the considerable journalistic attention" received by the proposal, and remarking that flatness has "unfortunately diverted attention from its innovations other than flatness"); Gerard M. Brannon, *What's with this Jazz about Tax Overhaul?* 71 TAX NOTES 260, 262 (1996) (the flat tax's elimination of the personal tax on investment income is "a little-noticed feature as well as a big one"); John S. Nolan, *The Merit of an Income Tax Versus a Consumption Tax*, 71 TAX NOTES 805, 806 (1996) ("the political rhetoric focuses upon the flatness of the rate of tax, but that is a red herring"); SLEMROD & BAKIJA, *supra* note 7, at 167 (the switch to a consumption base is a "more dramatic and unprecedented" change than amending the rate structure).

In some opinion surveys taken during the 1996 presidential campaign, most respondents with opinions favored the idea of a single rate of tax.[36] National opinion was not clearly in favor of a single rate, however. A poll taken after Steve Forbes' withdrawal from the campaign found an even split on "a flat-tax system, where everyone pays the same tax rate no matter what their income."[37] When survey participants were given an explicit choice between "a graduated income tax system, in which people with higher incomes pay a higher tax rate, or a flat tax system, in which everyone pays the same rate of tax regardless of income," the flat tax lost by 15 percentage points.[38] More recently, a poll taken in late 1997 gave respondents a choice between the "current system in which someone with more money pays a higher percentage of their [sic] income in taxes" and a "flat tax system in which all Americans would pay the same percentage of their income in taxes." The "current system" won a narrow victory, 51% to 45%.[39]

As is often true in polling, subtle differences in the wording of questions lead to major differences in results. The flat tax polls better against the "current system" than against a hypothetical "graduated income tax."[40] Jonathan Chait has suggested an interesting explanation of this phenomenon. According to Chait, many people believe—incorrectly—that the current system has so many loopholes that it is effectively regressive, despite its nominal progressivity.[41] Ironically, they favor a flat tax because they think

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36 Asked whether they favored or opposed "a flat tax system, in which all but low-income Americans would pay the same percentage of their income in taxes, regardless of how much money they make," 48% of American adults were in favor and 42% opposed. *Time/CNN/Yankelovich Partners Poll*, survey ending date Jan. 18, 1996, *available in* Nexis RPOLL file, accession number 0250300. Asked whether they favored "a flat tax—with a single low rate for federal income taxes and all or most deductions removed," 50% of American adults were in favor and 32% were opposed. *Princeton Survey Research Associates/Newsweek Poll*, survey ending date Jan. 26, 1996, *available in* Nexis RPOLL file, accession number 0250604.

37 The flat-tax system was supported by 48% of respondents and opposed by 48%. *ABC News/Washington Post Poll*, survey ending Aug. 5, 1996, *available in* Nexis RPOLL file, accession number 0268293.

38 The graduated income tax was the choice of 54%, and the flat tax of 39%. *NBC News/Wall Street Journal Poll*, survey ending Mar. 5, 1996, *available in* Nexis RPOLL file, accession number 0252528. A different survey, asking an almost identically worded question at about the same time, found 54% favoring the graduated tax and 45% favoring the flat tax. *ABC News/Washington Post Poll*, survey ending Mar. 17, 1996, *available in* Nexis RPOLL file, accession number 0260264.

39 *USA Today/CNN/Gallup Poll*, survey ending Nov. 23, 1997, *available in* Nexis RPOLL file, accession number 0288901.

40 *See* SLEMROD & BAKIJA, *supra* note 7, at 10-11 (citing polling results).

41 Chait, *supra* note 7, at 24. In fact, the current income tax *is* effectively progressive. Whether average rate progressivity is measured with respect to adjusted gross income or a more comprehensive measure of income, analysis of income tax burdens at different income levels reveals significant progressivity. *See* CONGRESSIONAL BUDGET OFFICE, ESTIMATES OF FEDERAL TAX LIABILITIES FOR FAMILIES BY INCOME CATEGORY AND FAMILY TYPE FOR 1995 AND 1999, at 10 tbl.3, 14-15 tbl.4 (1998).

that it would *increase* the tax burden on the wealthy by closing loopholes.

While it may not be easy to sell the American public on a flat rate of tax, it appears impossible to sell the American public on the Hall-Rabushka consumption tax base if the base issue is considered separately from the rate issue and from loophole closing. Asked in June 1996 whether they preferred "an income tax system that taxes both income from investments and income from wages equally, or a system with higher taxes on income from wages but no taxes on income from investments," those surveyed preferred taxing both sources of income, 53% to 31%.[42] Interestingly, when the same question had been asked five months earlier—before Steve Forbes' strong showing in several primaries had focused national attention on the flat tax—taxing both sources of income had been favored by a margin of only 41% to 36%.[43] The Hall-Rabushka tax base did not gain in favor as it gained in familiarity.

In light of the polling data, the decision by flat tax proponents to sell the rate rather than the base is clearly correct. "The flat tax" may have a chance with the American public; "the wage tax" (or even "the wage and business tax") does not. The flat tax proponents have exhibited political savvy in hiding the consumption tax base behind the flat rate.

B. All Things to All People

Perhaps recognizing that the consumption base issue cannot be hidden entirely, Hall and Rabushka have also sown confusion about the nature of the base. Marketing their plan as all things to all people, they claim that their system "puts a low tax rate on a comprehensive definition of *income*,"[44] and that it "moves toward the goal of taxing all *income* once . . . and achieving a broad *consumption* tax."[45] Politicians echo their claims. Dick Armey describes the base of the flat tax as embodying the policy that "[a]ll

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42 *NBC News/Wall Street Journal Poll*, survey ending June 25, 1996, *available in* Nexis RPOLL file, accession number 0259677. The phrasing of the question may be somewhat unfair to the flat tax; it ignores the tax burden imposed on old capital by the business portion of the flat tax. On the other hand, the phrasing of the question is consistent with the likely public perception of the flat tax as simply a wage tax. The business portion of the tax is hidden from public view.

43 *NBC News/Wall Street Journal Poll*, survey ending Jan. 16, 1996, *available in* Nexis RPOLL file, accession number 0249730.

44 Robert E. Hall & Alvin Rabushka, *The Flat Tax: A Simple, Progressive Consumption Tax*, *in* FRONTIERS OF TAX REFORM 27 (Michael J. Boskin ed., 1996) [hereinafter *Flat Tax II*] (emphasis added).

45 FLAT TAX I, *supra* note 11, at 63 (emphasis added). Herbert Stein has noted that the flat tax can be analogized to either an income tax or a sales tax, and that "the two different possible pictures probably contribute to the salability of the plan—one picture being appealing to those to whom income tax is a bad name and one to those to whom sales tax is a bad name." Herbert Stein, *The Uneasy Case for a Flat Tax*, *in* FAIRNESS AND EFFICIENCY IN THE FLAT TAX 102, 108 (Robert E. Hall et al. eds., 1996).

income should be taxed only once."[46] Michael Graetz has complained that the base of the flat tax amounts to putting "dark glasses and a false mustache" on a consumption tax to make it look like an income tax.[47] Graetz thinks that it would be difficult or impossible to sell the American public on the replacement of the income tax with a value-added tax, and that the bifurcated base has "deflected the public from realizing that the Forbes-Armey flat tax is a kind of value-added tax."[48]

Just as they claim that their tax base is at once income and consumption, Hall and Rabushka claim that their rate structure is at once proportional and progressive: "The good news is that the flat tax is progressive in that families with higher incomes pay a larger fraction of their income in taxes."[49] Their claims are technically accurate. When the focus is on marginal rates, a tax system with one rate above an exemption level is flat; when the focus is on average rates, the same system is modestly progressive. What is odd about their claims to both flatness and progressivity is that they never explain why it is "good news" that the tax is both flat and progressive. Not only do they never explain why average rate progressivity is desirable,[50] they offer a defense of flatness under which average rate progressivity is objectionable: "The principle of equity embodied in the flat tax is that every taxpayer pays taxes in direct proportion to his income. As incomes double, triple, or grow tenfold, tax obligations double, triple, or rise tenfold."[51] Since average rate progressivity violates this "principle of equity," one would expect Hall and Rabushka to believe it is *bad* news that higher income families would pay a larger fraction of their income in taxes. Instead they find it good news, perhaps because it allows them to obfuscate the rate issue as well as the base issue.

In any event, it is clear as a matter of marketing that the rate structure—in its something-for-everyone guise as the progressive flat tax—is the attraction and that the base of the tax could not be sold on its own (not even with obfuscation). The political link between base and rate calls for an examination of whether there is an underlying logical or philosophical link as well. Does a consumption base somehow imply a flat rate? Does a flat rate some-

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46 Armey & Tauzin, *supra* note 6.

47 MICHAEL J. GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX 216 (1997).

48 *Id.* at 219. Hall and Rabushka claim that the bifurcation of the base is necessary so that personal exemptions can be introduced into the wage tax. FLAT TAX I, *supra* note 11, at 55. As noted earlier, however, the same basic results could be obtained with a VAT and cash rebates equal to the tax on subsistence consumption. Zelenak, *supra* note 27.

49 FLAT TAX I, *supra* note 11, at 124.

50 They do indicate that it is desirable to have exemptions so that the poor pay no tax. *Id.* at 52, 89, 123. The flat rate on top of the exemptions produces average rate progressivity, but this makes average rate progressivity merely a side effect of tax exemption for the poor, not a policy objective in its own right.

51 *Id.* at 27.

how imply a consumption base? Or is there some overriding principle that implies both? If the answer to those questions is no, the public debate on tax reform would be better served by separating the base and rate issues, and considering each on its own merits.[52]

IV. Does an Overriding Concern for Efficiency Dictate Both a Consumption Base and a Flat Rate?

A. Taxes and Deadweight Loss: The Current Income Tax

Taxing any activity drives a wedge between the social value of the activity and its private value to the actor, and that wedge is a source of inefficiency. The income tax creates two such wedges—one for paid labor, and one for saving for future consumption. Consider first the labor-leisure distortion. If a taxpayer's (T's) labor is worth $100 a day, as measured by an employer's willingness to pay, a 20% wage tax makes T's labor worth only $80 to T. If he values tax-free alternative uses of his time (leisure or producing tax-free "imputed income") at $85, the tax will cause him to choose an alternative use. By causing T to choose an untaxed use of his time worth only $85, instead of a use worth $100, the tax has caused a $15 deadweight loss (also known as an excess burden).[53] An income tax also distorts the choice between present and future consumption, again resulting in deadweight loss. Suppose a taxpayer has $1000 to consume now, or to invest for greater consumption next year. The social value of investing $1000 for one year is $100, as measured by the pre-tax rate of return the taxpayer can obtain. If the tax rate is 20%, his choice is between consuming $1000 now and consuming $1080 next year. If he is indifferent between consuming $1000 now and $1085 next year (i.e., if he requires $85 compensation to defer his consumption for one year), the tax on investment income will change his decision from investment to current consumption. Again, the result is a deadweight loss.[54]

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52 *See* Charles E. McLure, Jr. & George R. Zodrow, *A Hybrid Approach to the Direct Taxation of Consumption*, *in* Frontiers of Tax Reform, *supra* note 44, at 70-71 (describing the base and rate structure of the flat tax as "two distinct and separable features," and setting aside the rate structure to concentrate on the tax base question).

53 Another way of understanding the same phenomenon is to think of the $20 tax revenue that would be produced by T's labor as a positive externality of T's work. Because T cannot capture the externality, he produces less than the socially optimal amount of paid labor when he chooses the tax-free alternative.

54 Both examples in the text illustrate the substitution effect—i.e., the tendency of taxpayers to substitute untaxed activities for taxed activities. In behavioral terms, the substitution effect may be partly or wholly counteracted by the income effect—i.e., the tendency of taxpayers to work or save more when they are taxed, to make up for the loss of wealth caused by the tax. It is often assumed, incorrectly, that a tax causes no deadweight loss if the two effects are behaviorally offsetting—if a tax on labor income causes no change in hours worked, or if a tax on investment income causes no change in savings rates. In

A progressive rate structure has an efficiency cost of its own. Because deadweight loss from taxation is proportional to the square of the marginal tax rate,[55] the most efficient rate structure is perfectly flat (for any given tax base and revenue goal). In moving from a perfectly flat rate structure to an equal-revenue structure with progressive marginal rates, the increased deadweight loss from higher marginal rates on more affluent taxpayers will exceed the decreased deadweight loss from lower marginal rates on poorer taxpayers.

B. Taxes and Deadweight Loss: The Flat Tax

Thus, there are serious efficiency critiques of both the base and the rate structure of the current income tax. Efficiency is very important to Hall and Rabushka, and they invoke it to justify both their consumption tax base and the flat rate.[56] How well does the flat tax fare on efficiency grounds? Consider first the base of the flat tax. It deals with the two tax distortions—between labor and leisure, and between present and future consumption—very differently. By not taxing the return on savings,[57] the flat tax eliminates tax distortion in consumption timing decisions. Because the flat tax continues to tax wages, however, it does *not* eliminate distortion in labor supply decisions. The flat tax does not achieve efficiency nirvana, or even approach it very closely.

Any tax based on behavior will distort behavior, with resulting deadweight loss. A tax not based on behavior would be the choice of an efficiency purist. The standard example of such a tax is a head tax, imposed in an equal amount on each person solely on account of existence. In addition to being politically impossible, however, a head tax sufficient to fund the federal government would not really be perfectly efficient. The tax could be avoided by having no income (or assets) with which to pay it, and thus at low income levels the tax *would* be based on behavior. The efficiency costs of what amounts to a 100% tax on low wage earners could be substantial. Nevertheless, a head tax approaches efficiency nirvana much more closely than does a consumption tax.

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fact, however, the deadweight loss is solely a function of the substitution effect, and may be substantial even if there is no change in observed behavior. *See* HARVEY ROSEN, PUBLIC FINANCE 310-12 (4th ed. 1995).

55 *See* JOSEPH STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 376 (1st ed. 1986).

56 FLAT TAX I, *supra* note 11, at 40-41, 70-72, 86-87 (consumption tax base), and at 84-86 (flat tax on wages).

57 Although the business portion of the flat tax nominally taxes investment income, expensing of investment under the business tax has the same effect as exempting from tax the normal return to capital on new investment. *See* Musgrave, *supra* note 31, at 735. Whether a version of the flat tax with graduated rates on wages would distort consumption timing decisions is discussed *infra* text accompanying notes 127-38.

Even with a head tax ruled out, and with the stipulation that the choice must be some form of income or consumption tax, a consumption tax is not the clear winner on efficiency grounds. Recall that there are two sources of inefficiency in an income tax—the labor-leisure distortion, and the present consumption-future consumption distortion.[58] A consumption tax can eliminate only the latter. An equal-revenue *income* tax would have a broader base, which means it could meet the government's revenue requirements at a lower rate. Compared to the consumption tax, the lower rate income tax would lessen deadweight loss from the labor-leisure distortion, at the cost of some deadweight loss from the distortion of consumption timing.

Which system would have less total deadweight loss is an empirical question. The key issue is not, as one might suppose, the responsiveness of savings to tax rates. Rather, it is whether individuals have utility functions separable between leisure and other commodities.[59] A pure consumption tax will minimize deadweight loss only if people "can be described as separating their work and savings decisions, first deciding how much to work and then how much of earnings to allocate to provision for the future."[60] If that is not how people behave, then the taxation of investment income will be necessary to minimize deadweight loss. Although some economists suspect the condition for optimality of consumption taxation comes close to existing in the real world,[61] the case has not been proven. Until it is, even efficiency purists must withhold judgment on the superiority of a consumption tax to an income tax; the efficiency link between a flat rate and a consumption base is not established. It is true that the flat tax involves only one kind of distortion, while a lower rate income tax involves two, but the efficiency goal is not to have the fewest *kinds* of distortion. Rather, it is to have the least *total* distortion. By that standard, a consumption tax is not a clear winner over an income tax.

What about the efficiency case for the rate structure of the flat tax? Despite its name, the flat tax is not really flat. It actually has two rates–a rate of zero on the wages exempted from the wage tax, and a single positive rate applied to the rest of the base. A *truly flat* flat tax would be more efficient. Eliminating the exemptions under the wage tax would make it possible to raise the same

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58 *See supra* text accompanying notes 53-54.

59 *See* David F. Bradford, *The Economics of Tax Policy toward Savings*, *in* THE GOVERNMENT AND CAPITAL FORMATION 11, 24-28 (George M. von Furstenberg ed., 1980) [hereinafter Bradford II].

60 *Id.* at 64.

61 *See id.*; Martin S. Feldstein, *The Welfare Cost of Capital Income Taxation*, 86 J. POL. ECON. S29 (1978).

amount of revenue with a significantly lower positive tax rate.[62] The increased marginal rate on the poor would cause less deadweight loss than the loss avoided by the decreased marginal rate on everyone else. Hall and Rabushka understand this proposition, but nevertheless call for large exemptions and a correspondingly higher flat tax rate. Their justification for the high exemption levels of the wage tax is their conception of fairness.[63]

Having made this efficiency concession in the rate structure in the interests of fairness, and having offered little more than intuition in support of their notion of fairness,[64] Hall and Rabushka have opened the door to others whose ideas of fairness[65] are different from their own, and who would strike a different balance between efficiency and fairness—perhaps involving graduated tax rates.[66] There is no reason to defer to Hall and Rabushka; nothing in their work indicates that they have any special expertise in deciding what is fair, or in balancing fairness against efficiency.

In sum, a single-minded concern for efficiency cannot justify the flat tax's linkage of a consumption base with a single positive

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62 FLAT TAX I, *supra* note 11, at 81 (indicating the same amount of revenue could be raised by various combinations of exemption levels and flat rates; as the exemption level decreases, the revenue-neutral tax rate also decreases).

63 *Id.* at 52, 55, 59.

64 *Id.* at 25-29 (discussion of fairness in taxation). This discussion is one of the weaker portions of the entire book. Three paragraphs consider the implications of various dictionary definitions of "fair" (*id.* at 25-26), as if Noah Webster were the leading authority on fair tax rates. Hall and Rabushka also offer standard conservative rhetoric likely to persuade only those not in need of persuasion. For example, "Politicians and intellectuals who support high tax rates to redistribute income to attain their egalitarian goals threaten individual freedom and self-reliance." *Id.* at 28. Their notions of fairness are entitled to little deference, especially since they contradict themselves on the crucial question of whether fairness requires progressive or flat average tax rates. *See supra* text accompanying notes 49-51.

The discussion of fair tax rates in the Report of the Kemp Commission is equally unsatisfying. The Report asserts that "graduated marginal rates violate the principle of fairness—that if a law applies to citizen A, it must equally apply to citizen B." Kemp Commission, *supra* note 15, at 424. The authors of the Report do not appreciate the vagueness of the application of this principle to the question of tax rate structure. Under one interpretation of the principle, it would merely require horizontal equity—that two taxpayers with the same earnings pay the same taxes. A graduated rate structure satisfies that requirement. Under another interpretation of the principle, it would require that everyone pay exactly the same dollar amount of tax. *See* Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 AM. J. TAX POL'Y 221 (1995) (arguing the only fair tax is a head tax). The Report explains neither why proportionality of tax burden is the proper interpretation of the fairness principle, nor why an exemption is fair despite the fact it makes average tax rates non-proportional.

65 "The case for drastic progression in taxation must be rested on the case against inequality—on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely." HENRY SIMONS, PERSONAL INCOME TAXATION 18-19 (1938).

66 In any event, the efficiency cost of modest rate graduation—for example, the cost of having a 15% bracket and a 25% bracket, instead of a single 20% rate—is likely to be insignificant. *See* SLEMROD & BAKIJA, *supra* note 7, at 165.

tax rate. From an efficiency standpoint, a consumption base is not clearly superior to an income base, and it is inferior to a head tax, or the nearest practical approximation thereof. As for rate structure, a flat rate above a large zero bracket is less efficient than a lower flat rate with no zero bracket. A relentless pursuit of efficiency cannot explain either the base or the rate of the flat tax, let alone establish a link between them.

V. Does an Overriding Concern for Simplicity Dictate Both a Consumption Base and a Flat Rate?

Simplicity is a major virtue to Hall and Rabushka, and they claim for the flat tax a decisive simplicity advantage over the income tax.[67] They are correct that the flat tax would be simpler than current law. What they do not say, however, is that the bulk of the simplification comes from the change in the base of the individual tax, and not from elimination of graduated rates. A graduated rate version of their tax base would be nearly as simple as their proposal. Moreover, their decision to bifurcate the tax base to make exemptions possible is a major sacrifice of simplicity in the interests of fairness; once the decision has been made to have a bifurcated base and exemptions, the additional complexity of graduated rates is minor.

A. Simplification: A Question of Base or Rates?

Why are Hall and Rabushka able to fit their tax return on one side of a postcard, when the current Form 1040 requires two sides of a full-sized sheet of paper, or many more sides of paper for taxpayers required to use attachments? It is not because of flat rates. Of the 69 lines on the 1998 Form 1040, exactly one (line 40) is devoted to deriving tax liability from taxable income. Most of the lines are dedicated to the determination of taxable income. Taxing individuals only on wages, rather than on all sources of income, *is* a major simplification.[68] There are three caveats, however. First, for the 45 to 50 million taxpayers using Form 1040A or Form 1040EZ, current filing already approaches postcard simplicity.[69] Second, a substantial part of the simplification of the tax base comes from the elimination of deductions, which is a separate issue from both income versus consumption taxation and flat versus graduated rates. A graduated income tax without personal deductions would also be simpler than current law. Finally, the tax base of the flat tax, although simpler than current

67 Flat Tax I, *supra* note 11, at 5-6 (the income tax is "a nightmare of complexity"), 59 (the flat tax's postcard return), 132 (the flat tax will eventually become law "because of the American taxpayer's demand for a true simplicity").

68 This is conceded by critics of the flat tax. *See, e.g.*, Graetz, *supra* note 47, at 227.

69 *See id.* at 259.

law, has its share of complexities. They include: distinguishing between wage income subject to the personal tax and capital income not subject to the tax,[70] the definition of dependents for purposes of the family size adjustments in exemption levels,[71] the need for individuals to file the more complicated business returns for their small businesses (which could be as small as renting out a room in one's home),[72] the need on business returns to distinguish non-deductible personal consumption from deductible business expenses,[73] the need on business returns to distinguish between taxable sales and nontaxable interest income,[74] the need for rules on the aggregation or disaggregation of businesses for return filing purposes,[75] and the need for complex rules for the carryover of business tax "losses" caused by the expensing of large investments.[76]

With these caveats, the simplification of the tax base of personal tax returns still would be substantial. By contrast, the simplification achieved by flatness would be less impressive,[77] and the nature of the simplification gains from flatness probably would surprise most people. The difference in the amount of arithmetic required to apply one rate or more than one rate to the tax base is trivial—especially since the tax tables do the arithmetic for most taxpayers.[78] It may be, however, that a math-phobic public wrongly supposes the complexity of the income tax flows largely from the arithmetic of graduated rates. If so, the flat tax label is well-chosen to take advantage of that misapprehension.

A nontrivial simplification that would follow from a single rate tax is an end to taxpayers' incentive to shift income among family members and controlled entities to achieve taxation at lower rates.[79] This gain would be modest, however, for two reasons. First, current law has already taken most of the fun out of

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70 *See* Musgrave, *supra* note 31, at 734.

71 *See* GRAETZ, *supra* note 47, at 227.

72 *See id.* at 229.

73 *See id.* at 230; Alan L. Feld, *Living With the Flat Tax*, 48 NAT'L TAX J. 603, 607, 613 (1995).

74 *See* SLEMROD & BAKIJA, *supra* note 7, at 216.

75 *See* Feld, *supra* note 73, at 609-10.

76 Loss carryovers cause complications under the existing income tax (I.R.C. § 172 (1994 & Supp. III 1997)), but they would be a bigger problem under the flat tax, for two reasons. First, expensing of investment will make losses more common. Second, achieving the flat tax goal of neutrality between saving and consumption requires adjustment of loss carryforwards to reflect the time value of money and inflation. *See* Charles E. McLure, Jr., *The Simplicity of the Flat Tax: Is It Unique?* 14 AM. J. TAX POL'Y 283, 294-95 (1997).

77 *See* Stein, *supra* note 45, at 103 (flat tax "simplification results almost entirely from the redefinition of the base and hardly at all from the flatness of the tax").

78 "I have sometimes remarked that, given the existence of rate tables that cover the vast majority of individual taxpayers, graduated rates should pose a problem primarily for those with astigmatism." McLure, *supra* note 76, at 289 n.13.

79 *See* GRAETZ, *supra* note 47, at 231.

income-shifting,[80] through the "kiddie tax"[81] and the compressed tax rate schedule for trusts.[82] Second, only a true single rate tax—with no zero rate due to exemptions—can eliminate all opportunity for income-shifting. Because of the zero bracket, some incentive for income-shifting would remain under the flat tax.[83]

There is another kind of income-shifting—between years rather than between taxpayers. Because of the time value of money, this form of shifting does not require rate differences to be attractive. Even if the tax rate is the same in all years, there is incentive to shift income to later years. Hall and Rabushka hint that the flat tax would put an end to income-shifting between years,[84] but that is simply not true.[85]

In any event, playing income-shifting games makes sense only for high bracket taxpayers—a small percentage of all taxpayers—for whom the tax savings justify the transaction costs. Even for these taxpayers, the complexity is in the nature of a self-inflicted wound. The complaint of Hall and Rabushka about the "nightmare of complexity"[86] of current law is that it makes "the ordinary citizen [feel] overwhelmed and threatened by the Internal Revenue Service."[87] The "ordinary citizen," however, is unaffected by the complexities of income-shifting.[88]

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80 *See id.* at 231.

81 The "kiddie tax" taxes unearned income of children under 14 at their parents' marginal rate. I.R.C. § 1(g) (1994 & Supp. III 1997). Hall and Rabushka might respond, however, that the kiddie tax is itself a moderately complex provision. By contrast, the flat tax reduces the incentive for income-shifting without the need for a special and somewhat complex provision.

82 The compressed rate schedule taxes all trust income over $8450 at 39.6%. I.R.C. § 1(e) (1994); Rev. Proc. 98-61, 1998-52 I.R.B. 18, § 3.01 (inflation adjustment).

83 In addition, income shifting to entities exempt from tax (either de jure or de facto) would remain. These include charities, foreign businesses, and businesses with loss carryforwards.

84 "Because it is high-income taxpayers who have the biggest incentive and the best opportunity to use special tricks to exploit tax-rate differentials, applying the same tax rate to these taxpayers for all of their income *in all years* is the most important goal of flat-rate taxation." *Flat Tax II*, *supra* note 44, at 28 (emphasis added). This is a strange argument in another respect. It does not say that graduated rates are wrong in principle; it merely complains that the rich are *sometimes* able to avoid them. It is not obvious that the best response to that problem is to change the law so that the rich are *always* able to avoid them.

85 *See* GRAETZ, *supra* note 47, at 232.

86 FLAT TAX I, *supra* note 11, at 5.

87 *Id.* at 6.

88 As others have demonstrated, it is possible to achieve tremendous simplification for the majority of taxpayers, within the context of a graduated income tax. *See, e.g.*, GRAETZ, *supra* note 47, at 259-60; Jonathan Barry Forman, *Simplification for Low-Income Taxpayers: Some Options*, 57 OHIO ST. L.J. 145, 197-200 (1996) (describing a return-free income tax system for millions of taxpayers); Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121 (1989); SLEMROD & BAKIJA, *supra* note 7, at 246-48 (describing a proposal by Representative Gephardt for an income tax system that would be return-free for most taxpayers).

Charles McLure claims another simplification advantage for a single rate tax system—that it makes surrogate taxation of investment income more attractive.[89] For example, McLure describes the treatment of interest payments under the flat tax—nondeductible to borrowers and nontaxable to lenders—as a "flipping" of current treatment. As long as interest rates adjust to reflect the tax regime, taxpayers should be indifferent between the current rules (of deductibility and taxability[90]) and the flat tax rules (of no tax consequences), *if* borrowers and lenders pay the same tax rate.[91] Thus, a flat rate facilitates a most simple tax treatment of interest payments, under which denying a deduction to the borrower serves as a surrogate for taxing the lender. Similarly, using a tax on business as a surrogate for a tax on dividends received by business *owners* is more attractive if individuals and businesses are taxed at the same rate.[92]

The problem with the surrogate taxation case for a single rate tax is that surrogate taxation can be used even if the rates of the wage tax are graduated. David Bradford's "X tax" has the same bifurcated base as the flat tax, but a different rate structure.[93] The X tax has a graduated rate wage tax, and a flat business tax with a rate equal to the top wage rate. It achieves precisely the same simplification from surrogate taxation as does the flat tax. It does so at the cost of arguable unfairness to low bracket owners of capital, for whom the surrogate business tax rate is higher than their own wage tax rate.[94] If little capital is owned by low bracket taxpayers, however, and if the equity gains from a graduated wage tax are deemed substantial, that may be a price worth paying. In any event, the choice of the flat tax over the X tax as a means of implementing surrogate taxation must be made on debatable equity grounds; both taxes can achieve the same simplicity gains.

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89 *See* McLure, *supra* note 76, at 289-90. McLure's analysis is consistent with Hall's and Rabushka's description of the business tax as a surrogate tax on the investment income of individuals: "The interest, dividends, and capital gains received by individuals . . . have already been taxed under the business tax." FLAT TAX I, *supra* note 11, at 125.

90 I.R.C. §§ 163 (providing for the general deductibility of interest expense, but with important exceptions), 61(a)(4) (including interest payments in gross income) (1994 & Supp. III 1997).

91 *See* McLure, *supra* note 76, at 289.

92 *See id.* McLure correctly notes that the simplicity advantage of surrogate taxation has nothing to do with the choice between income and consumption tax bases. A flat rate facilitates surrogate taxation under either tax base. *Id.*

93 David F. Bradford, *What Are Consumption Taxes and Who Pays Them?* 39 TAX NOTES 383, 385-86 (1988) [hereinafter Bradford III].

94 The X tax reaches correct surrogate tax results, of course, for all capital owned by top bracket individuals. Even for an individual not in the top wage tax bracket, the overtaxation under the surrogate tax is minor, if she has large amounts of investment income. In that case, if the investment income were taxed directly to her, most of it would be taxed in the top bracket.

B. Straining at Gnats and Swallowing Camels: A *Really* Simple Tax

Hall and Rabushka have intentionally passed up the opportunity to make their tax really simple, and they have done so because they believe a really simple tax would not be fair. The flat tax is a bifurcated version of a value-added tax.[95] It would be possible to use a plain, nonbifurcated VAT to tax all consumption at a single rate. Compared to the flat tax, this would have the huge simplification advantage of not requiring any individual tax returns. Hall and Rabushka concede that a VAT would be a "really simple tax," even compared to the flat tax, but they reject a VAT because the absence of exemptions (i.e., the zero bracket of the wage tax) means it would not be fair.[96] They even say that a tax without the average rate progressivity created by exemptions would be unfair.[97] Although the difference between a simple VAT and the flat tax *appears* to be one of base, it is better understood as a difference in rate structure. The *base* of both systems is consumption; the difference is that the bifurcated flat tax applies a *rate* of zero on subsistence consumption financed out of current wages.

Given that many taxpayers will find even a postcard return daunting, the bifurcation of the base of the flat tax is a major compromise of simplicity.[98] Having swallowed this camel of complexity in the name of fairness, they are poorly positioned to object to the gnat of additional complexity associated with graduated rates.[99] They can argue that an exemption is fair but graduated rates are not. The argument must then be waged not over simplicity, however, but over competing concepts of equity. If Hall and Rabushka are willing to give up the simplicity of a VAT in the service of their idea of fairness, they cannot hope to convince those

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95 *See supra* text accompanying notes 24-27.

96 FLAT TAX I, *supra* note 11, at 55.

97 "[A] value-added tax is unfair because it is not progressive." *Id.* This is a surprising claim, given their earlier assertion that proportionality of tax burdens is a "principle of equity." *Id.* at 27. Perhaps what they really believe is that fairness requires a tax exemption for subsistence wages, and that average rate progressivity is a side effect of a subsistence exemption. Or perhaps fairness is not really the main point of bifurcation. In a question-and-answer section at the end of the second edition, Hall and Rabushka mention another reason for bifurcation: "If individuals did not file returns, advocates of more government spending could promise voters new benefits without higher costs." *Id.* at 121.

98 Other commentators have noted that any tax that requires individual returns will be much more complex—in the view of tens of millions of middle-class taxpayers—than a VAT or a retail sales tax. *See, e.g.*, GRAETZ, *supra* note 47, at 206; Musgrave, *supra* note 31, at 732-33.

99 *See* SLEMROD & BAKIJA, *supra* note 7, at 138 (including individuals in the tax collection process is significantly more complicated than collecting all taxes from businesses, but taxing individuals at graduated rates does not by itself "contribute any significant complexity").

who believe in the fairness of graduated rates that progressive marginal rates are ruled out by complexity.

It would be easy to convert the flat tax to a tax with the same bifurcated base, but with graduated rates applied to the wage portion of the base.[100] This approach has been suggested by David Bradford, and by Charles McLure and George Zodrow.[101] If one believes that that system would be fairer than the flat tax, the almost trivial additional complexity is not a substantial objection.

C. Simplicity and a Flat Income Tax

As the preceding discussion has demonstrated, there is no convincing simplicity link between the Hall-Rabushka tax base and a flat rate tax. Even if one is persuaded—in part because of simplification—that the Hall-Rabushka tax base should replace the income tax, the question of the rate structure of the wage tax remains open. A desire for simplification does not dictate the answer. A person who values tax simplification might rationally support a graduated rate version of Hall-Rabushka. The other way of unlinking the base and rate reforms would be a flat income tax. If there is no compelling simplicity-grounded objection to a consumption base without a flat rate, is there any compelling simplicity objection to a flat rate without a consumption base? The Hall-Rabushka proposal could be converted to a kind of income tax by replacing the business tax's expensing of investments with economic depreciation. Expensing of investments under Hall-Rabushka is the economic equivalent of exempting the return on the investments from tax; allowing only economic depreciation would eliminate the exemption, thus making the system a form of income tax. Although this form of an income tax could have graduated rates on wages, a flat version of the tax has the arguably attractive feature of taxing labor income and capital income at the same rate. Interestingly, for all their emphasis on the importance of taxing consumption rather than income, Hall and Rabushka mention partial expensing of investment (presumably with depreciation of the remaining cost) as an acceptable variation on their

100 It would not, however, be practical to graduate the business tax in a way that made policy sense—i.e., in accordance with the income levels of business owners. Michael Graetz questions "why wages but not investment income should be subjected to progressive tax rates." GRAETZ, *supra* note 47, at 219. Rough justice might be achieved, however, by setting the rate of the business tax equal to the top rate of the wage tax, on the assumption that most business income accrues to high-income persons. *See* the discussion *supra* text accompanying notes 93-94.

101 BRADFORD I, *supra* note 35, at 76-82, 329-34; Bradford III, *supra* note 93, at 384-85; McLure & Zodrow, *supra* note 52, at 72.

proposal.[102] Partial expensing results in a hybrid income-consumption tax.[103]

Replacing expensing with depreciation would complicate the business tax, especially if depreciation deductions are adjusted for inflation.[104] All the increase in complexity would be on the business tax side, however. If the main point of simplification is making taxes simpler for the typical wage earner—as Hall and Rabushka suggest it is—then this innovative version of a flat rate income tax would be almost as simple as the flat tax itself.

D. Summing Up

The flat tax linkage of consumption base and flat rate is not explained by an overriding concern for simplicity. A true overriding concern for simplicity would produce some form of consumption tax not requiring individual returns. The flat tax itself has no significant simplicity advantage over two competing tax systems, neither of which links a flat rate with a consumption base: the flat tax base with graduated rates on wages, and a flat rate form of income tax derived from the flat tax.

VI. Consumption Taxes, Flat Taxes and Two Versions of Neutrality

The two strongest technical arguments for why a consumption tax should also be a flat tax relate to two neutralities. The first argument is that a cash flow version of a consumption tax must have a flat rate if it is to achieve neutrality between present and future consumption. The second argument is that a tax on labor income must have a flat rate if it is to achieve neutrality between persons with equal labor endowments but different lifetime earnings patterns. Both arguments are examined in this section, as are the implications of those arguments for the unusual Hall-Rabushka bifurcated tax base, which is neither a traditional cash flow tax nor a simple wage tax. Although the arguments create a stronger link between a consumption base and a flat rate than the simplicity and efficiency arguments, in the end they are not persuasive.

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102 Flat Tax I, *supra* note 11, at 82 (explaining that partial expensing, rather than full expensing, would make possible a reduction in the revenue-neutral flat tax rate).

103 *See* Arnold C. Harberger, *Tax Neutrality in Investment Incentives*, *in* The Economics of Taxation 299, 307-09 (Henry Aaron & Michael Boskin eds., 1980).

104 Charles McLure rightly points out that although "[t]he idea of replacing expensing with depreciation allowances is 'straightforward'; implementation of it is not, given our ignorance of economic depreciation rates." McLure, *supra* note 76, at 293 n.21.

A. A Cash Flow Consumption Tax and the Timing of Consumption

1. The Case for a Flat Tax

Until they were recently overshadowed by the flat tax, the most prominent proposals for replacing the income tax with a consumption tax followed the cash flow model.[105] The USA Tax is the leading current cash flow proposal.[106] Under a cash flow tax, all sources of income are subject to the individual tax, but only if consumed rather than saved.

A common argument against the income tax, discussed earlier in this Article,[107] is that it distorts individuals' choices between current consumption and saving for future consumption. The tax on investment income drives a wedge between the social return on investment and the individual investor's return on investment.[108] It is not clear that this distortion should be eliminated, when the cost of doing so is greater distortion of labor-leisure decisions.[109] Assuming the desirability of the goal, however, the distortion can be removed in one of two ways. A wage tax—which imposes no tax on investment income—obviously eliminates the wedge, and thus the distortion. A cash flow consumption tax can also eliminate the distortion, but only if it taxes an individual's consumption at the same rate, regardless of when it occurs. If the tax rate on future consumption out of savings is higher than the rate on present consumption, then a cash flow tax shares the income tax's vice of distorting consumption timing decisions. Living frugally now, in order to consume at a higher level later, is discouraged by a progressive cash flow tax.

Suppose a taxpayer earns $30,000 in wages this year (period 1) in a tax-free utopia. After spending $20,000 on her basic needs, she has $10,000 of discretionary income. She may decide to consume that $10,000 now, or she may decide to invest the $10,000 with an eye toward increased consumption in period 2. If she invests the $10,000 at the going rate of return, it will grow to $15,000 by period 2. Her choice is between consumption now, or 50% greater consumption later. To put the same point differently, the choice is between consumption in period 1 of $10,000, or consumption in period 2 with a present value, when viewed from period 1, of $10,000.

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105 *See, e.g.*, William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); DAVID F. BRADFORD AND THE U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 101-128 (2d ed. rev. 1984) [hereinafter BLUEPRINTS].

106 *See supra* text accompanying notes 18-20.

107 *See* note 54, *supra* and accompanying text.

108 *See supra* text accompanying note 54; BLUEPRINTS, *supra* note 105, at 46-47.

109 *See supra* text accompanying notes 58-61.

Now suppose there is a cash flow tax, imposed at a flat rate of 20%, with a $20,000 exemption. After spending $20,000 on her basic needs, the taxpayer has $10,000 of discretionary income. If she saves none of it, she will pay $2000 in tax, and be able to consume $8000. She may decide instead to invest the entire $10,000. No tax is currently due if the $10,000 is saved. The $10,000 will grow to $15,000 by period 2. If her period 2 consumption is subject to the same 20% tax rate, the savings will enable her to consume $12,000 in period 2 (after paying a $3000 tax). As in the no-tax world, her choice is between consumption now, or consumption of equal present value later. Although the tax has reduced her opportunities for both present and future consumption, it has not distorted the choice.

But now suppose that the rate structure is progressive, so that if the taxpayer goes on a consumption binge in period 2—spending the savings on top of her period 2 wages—the marginal tax rate on her $15,000 dissavings will be 40%. The after-tax consumption from the savings will be only $9000.[110] In present value terms, the choice is between $8000 consumption now, or consumption with a present value of only $6000 later.[111]

2. The Objections to the Case

If avoiding distortion in the timing of consumption decisions is the reason one wants a cash flow consumption tax, it has commonly been thought that the tax must have a single rate, which remains constant over time.[112] Notice, however, that graduated rates in a cash flow tax have two effects, only one of which is objec-

110 This $9000 is only 12.5% more than the alternative of $8000 consumption in period 1. The progressive cash flow tax has driven a large wedge between the 50% social return on savings and her 12.5% private rate of return. This wedge may have two behavioral effects on the taxpayer, pushing in opposite directions. The low after-tax return on savings may discourage her from saving. This is the substitution effect—the substitution of lightly taxed current consumption for heavily taxed future consumption. But if she is a "target saver"—i.e., if she is saving in order to be able to consume a specific dollar amount in period 2—the increased tax burden will cause her to save more to meet her goal. This is the income effect. Economic theory cannot predict which effect will dominate. The greater tax burden on future consumption may decrease savings, increase savings, or leave savings unchanged. The inefficiency resulting from taxation, however, depends solely on the distortion caused by the substitution effect. Thus, a graduated cash flow tax may cause substantial deadweight loss even if the net result of the income and substitution effects is no change in observed behavior. *See* ROSEN, supra note 54, at 310-12.

111 By hypothesis, the present value in period 1 of consumption in period 2 is two-thirds of the amount consumed in period 2.

112 Edward McCaffery goes so far as to say that the potential of a progressive cash flow tax to penalize savers vis-a-vis consumers makes a progressive cash flow tax "not really a pure consumption tax." Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283, 350 (1994).

Of course, one may support a cash flow tax for reasons that have nothing to do with neutrality toward the timing of consumption decisions, in which case there would be no particular reason the tax should be flat. McCaffery, for example, advocates a cash flow tax for reasons unrelated to timing neutrality; his tax would have graduated rates. *Id.* at 350-

tionable in terms of consumption tax theory. The objectionable effect arises from the fact that graduated rates may tax an individual's consumption at different rates in different years, *if* he consumes at different levels in different years. The other effect is that if Taxpayer B consistently consumes more than Taxpayer A, the progressive tax will tax B at higher rates than A. This second effect is unobjectionable in consumption tax theory, and will be attractive to many on vertical equity grounds.

What if one wants both to eliminate tax distortions in the timing of consumption decisions, and to tax higher consumers more heavily than lower consumers? How then to choose a rate schedule for a cash flow tax, balancing these competing objectives? At one extreme, suppose people save, and dissave, only for the purpose of smoothing out consumption between high and low income years. In that case, A's consumption and B's consumption are both level over time, and B's is always higher than A's. On these facts, the objectionable effect of graduated rates is not implicated. A will be taxed at the same rate in all years, B will be taxed at the same rate (but different from A's) in all years, and neither will be discouraged from saving by the tax system. The vertical equity goal of graduated rates can be achieved without distorting the timing of consumption decisions.

More generally, the choice should be graduated rates if individuals' consumption patterns are fairly level over time, and if the differences in lifetime consumption levels among individuals are large.[113] Conversely, if individuals commonly save to finance higher consumption levels in the future, and if differences in lifetime consumption levels among individuals are small, the concern about distortion dominates the desire for vertical equity, and the tax should have a flat rate.

What is the evidence? Don Fullerton and Diane Lim Rogers recently have demonstrated—to no surprise—that there is significant inequality in the lifetime labor endowments, or human capital, of Americans.[114] At the tenth percentile of the distribution, the value of the labor endowment is $387,534; at the fiftieth percentile the value is $714,292; and at the ninetieth percentile the value is $1,218,735.[115]

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53. The leading legislative proposal for a cash flow tax also has graduated rates. USA Tax Act of 1995, S. 722, 104th Cong. (1995).

113 This situation is implicit in William Andrews' preference for a progressive consumption tax. He explains that rate graduation is not inconsistent with tax neutrality between present and deferred consumption, "from an equal-consumer perspective." William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947, 954 (1975).

114 Although labor endowments are not perfect substitutes for lifetime consumption levels, they are closely correlated.

115 DON FULLERTON & DIANE LIM ROGERS, WHO BEARS THE LIFETIME TAX BURDEN? 70 tbl.3-2 (1993). The values are in 1984 dollars. There is also strong evidence that income

The life-cycle, or permanent income, hypothesis holds that individuals save and dissave in order to consume fairly evenly over the years of their lives.[116] Although it is not clear exactly how much consumption smoothing occurs, economists commonly assume that there is sufficient smoothing to make even one year's consumption a reasonable proxy for lifetime income.[117] All this suggests—although it does not prove—that interpersonal differences in consumption dominate intertemporal differences, so that the major fairness benefit from graduated rates justifies the minor distortion of the savings decisions of those unusual persons who prefer uneven lifetime consumption patterns.[118]

Moreover, the nature of the dominant effect of a progressive cash flow tax on consumption timing may not be objectionable to most consumption tax proponents. Perhaps the best summary of the evidence is that savings are used to smooth lifetime consumption—in particular, income from peak earning years is used to finance consumption in retirement—but that even with this smoothing, the typical lifetime age-consumption profile is hump-shaped. That is, consumption peaks in peak earning years, and declines significantly in retirement.[119] If that is correct, it has an interesting implication for the effect of a progressive consumption tax on consumption timing neutrality. If the most common sort of lifecycle savings defers consumption from a high-income, high-consumption year, to a low-income, low consumption retirement year, then a progressive cash flow tax actually creates a bias in *favor* of future consumption in the typical case.

Let us return to the previous example of the taxpayer saving $10,000 in period 1, when the marginal rate is 20%, in order to finance consumption in period 2. This time, however, let us suppose that even with the savings, consumption is lower in period 2 than in period 1, and the marginal tax rate in period 2 is only 10%. The $10,000 grows to $15,000 by period 2 and, after paying a 10%

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inequality in the United States has increased in recent years. *See* Lynn A. Karoly, *Trends in Income Inequality: The Impact of, and Implications for, Tax Policy*, *in* TAX PROGRESSIVITY AND INCOME INEQUALITY 95 (Joel Slemrod ed., 1994); SLEMROD & BAKIJA, *supra* note 7, at 55-58 (data on growing income inequality between 1977 and 1990).

116 *See* MILTON FRIEDMAN, A THEORY OF THE CONSUMPTION FUNCTION 20-31 (1957); Franco Modigliani & Richard Brumberg, *Utility Analysis and the Consumption Function: An Interpretation of Cross-section Data*, *in* POST-KEYNESIAN ECONOMICS 388 (Kenneth K. Kurihara ed., 1954).

117 *See* Michael J. Boskin, *A Framework for the Tax Reform Debate*, *in* FRONTIERS OF TAX REFORM, *supra* note 44, at 10, 19 ("consumption in any year may well be a better proxy for permanent income than is income in that year").

118 This assumes, of course, that one begins by accepting the vertical equity argument for graduated rates.

119 *See generally* Orazio P. Attanasio, *Personal Savings in the United States*, *in* INTERNATIONAL COMPARISONS OF HOUSEHOLD SAVINGS 57 (James M. Poterba ed., 1994) (providing a detailed and sophisticated analysis of lifetime income, savings, and consumption, based on Consumer Expenditure Survey data).

tax, the taxpayer can consume $13,500. Viewed from period 1, that future consumption has a present value of $9000, which is *greater* than the $8000 period 1 consumption alternative (after paying a 20% tax on $10,000).

It seems quite probable that the most common effect of a progressive cash flow tax on consumption timing will be a distortion in favor of deferred consumption. This distortion would, of course, still be a violation of consumption timing neutrality, but for those who support a consumption tax in order to encourage savings, it should not be objectionable.[120] It may even be an attraction.

There are four additional considerations pointing toward the acceptability of graduated rates in a cash flow tax, despite the impact on consumption timing decisions. First, the mere fact that an individual's consumption is not perfectly level over time does not mean that graduated rates will cause distortions. If tax brackets are fairly wide—encompassing several tens of thousands of dollars within a single bracket—they can accommodate substantial variations in annual consumption without subjecting an individual to different tax rates in different years.

Second, *Blueprints for Tax Reform* describes a cash flow tax system in which taxpayers are allowed to opt out of cash flow treatment for some savings; opting out would result in no deduction for savings, but also no tax on investment return.[121] Taxpayers could use this flexibility to average their consumption for tax purposes, thus avoiding the distortion that would result from different tax rates applying in different years.[122]

Third, for taxpayers with very unequal consumption levels within a period of a few years, tax base averaging rules, similar to the repealed income averaging rules,[123] could be provided.

Finally, there is a strong argument that the goal of applying the same tax rate to an individual over a period of many years is quixotic. One Congress cannot bind later Congresses;[124] tax rates will inevitably change over time as economic conditions, revenue

120 The House-passed "Tax Code Termination Act" calls for elimination of "the bias against savings and investment." H.R. 3097, 105th Cong. § 3(a)(4) (1998). It seems unlikely the House Republicans would object strenuously to a tax bias in favor of savings and investment.

121 BLUEPRINTS, *supra* note 105, at 110-11.

122 *See id.* at 112-13.

123 Former I.R.C. §§ 1301-1305, *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 141, 100 Stat. 2085, 2117 (1986).

124 Kyle D. Logue offers several suggestions—some of them quite creative—as to how the government might credibly commit itself to a particular tax policy, if it desired to do so. Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment*, 94 MICH. L. REV. 1129, 1181-94 (1996). Logue does not, however, suggest that Congress use any of these devices to commit future Congresses to a particular rate structure.

needs, and congressional attitudes change.[125] This reality suggests that there is no point in enacting a flat tax to pursue the consumption tax goal of neutrality in the timing of consumption decisions, because neutrality requires the tax rate to remain unchanged over decades, and that cannot happen.[126] That impossibility leaves the greater interpersonal fairness of graduated rates as the only achievable goal; it wins by default.

3. Relating the Case to the Bifurcated Base of the Flat Tax

The flat tax can be understood as an unusual version of a cash flow tax, using a look-through model of individuals' investments in businesses. When an individual invests wages in a business he is not entitled to a wage tax deduction for making the investment. He can be viewed, however, as benefitting indirectly from the ability of the business to expense the assets it buys with his money.[127] Similarly, when those assets produce business income, the investor formally pays no tax, but the tax the business pays can be viewed as paid on behalf of the investor, like a withholding tax.[128]

The clearest case for viewing the flat tax as a kind of cash flow tax is the wage earner with a sole proprietorship business on the side. If he takes some of his wages and uses them to buy assets for his business, the net tax effect will be the same as under a cash flow tax, if the wage tax and the business tax share the same rate. The savings from the business tax deduction will offset the taxation of the wages under the wage tax,[129] just as a savings deduction would offset the tax on wages under a standard cash flow tax. If he consumes the income generated by the assets, rather than reinvesting it in the business, that income will be taxable to him under the business tax, with the same result as if he had been taxed on consumed income under a standard cash flow tax.

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125 *See* GRAETZ, supra note 47, at 203-04; C. EUGENE STEUERLE, THE TAX DECADE 135, fig.8.3 (1992) (showing changes in average and marginal income tax rates at several income levels from 1955 to 1990).

126 Strictly speaking, avoiding distortion between present and future consumption does not require that the tax rates *actually* be the same in both years. It requires only that at the time the taxpayer makes the decision to consume or save, he *believes* the rate will be the same in both years. The history of changes in United States income tax rates, however, would give taxpayers under a cash flow tax little reason to have that belief.

127 *See* Stein, *supra* note 45, at 107.

128 This is how Hall and Rabushka explain the business tax: "The business tax is a giant, comprehensive withholding tax on all types of income other than wages, salaries, and pensions. . . . As a result, all income that people receive from business activity has already been taxed. Because the tax has already been paid, the tax system does not need to worry about what happens to interest, dividends, or capital gains after these types of income leave the firm . . . ." FLAT TAX I, *supra* note 11, at 61.

129 This result assumes the taxpayer has enough other business income to make the deduction for the cost of the assets fully useable.

If the flat tax base is analogized to a cash flow tax, must the tax be flat in order to achieve tax neutrality toward the timing of consumption? Perhaps surprisingly, a variation on the flat tax, with a flat rate for the business tax but graduated rates for the wage tax, has consumption timing neutrality.[130] For example, David Bradford's "X tax,"[131] which has a flat business tax at the same rate as the top wage tax rate, features consumption timing neutrality. *Any* combination of a graduated wage tax and a flat business tax has consumption timing neutrality, regardless of the relation between the business tax rate and the top wage tax rate.[132] The X tax approach of setting the business tax rate equal to the top wage rate seems the most attractive option, however, on the assumption that most business income accrues to high-income persons.[133]

Suppose the wage tax has graduated rates, with the top wage tax rate equal to the business tax rate of 40%. Consider again the wage earner with a business on the side. He has $100 of wages, subject to the wage tax at the rate of 25%.[134] If he opts for current consumption, he will pay a tax of $25, and consume $75. If he chooses instead to invest those wages in the business, he will be able to spend $125 on business assets. Deducting $125 from the 40% business tax generates a tax savings of $50, so the after-tax cost of the investment is $75, which equals the wages he has available to invest after paying the $25 wage tax. Viewing the first year in isolation, the net effect of the two taxes is a 25% *negative* tax: the burden of the lower rate wage tax is more than offset by the benefit of the deduction against the higher rate business tax.

The assets generate income at the normal rate of return in the economy—say, 10% for one year. One year later, the business has the assets, still worth $125,[135] and the $12.50 income from the assets. The taxpayer then decides he wants to devote the entire $137.50 to consumption, which requires selling the assets. He will have to pay the 40% business tax on the entire $137.50,[136] so the

130 *See* Bradford III, *supra* note 93, at 385-86.

131 *Id.*

132 For that matter, the combination of a wage tax and a flat business tax has consumption timing neutrality no matter what rate structure is chosen for the wage tax. *See infra* text accompanying notes 137-38.

133 *See supra* text accompanying notes 93-94 (discussing surrogate taxation under the X tax).

134 This rate is the average or effective rate on the $100 wages. The analysis does not depend on what marginal rate structure produces that average rate.

135 For simplicity of illustration, the example assumes the assets suffer no economic depreciation.

136 The $12.50 income is obviously subject to tax, since it was not reinvested in business assets. The other $125 is subject to the business tax because the assets were sold, and proceeds from the sale of plant and equipment are subject to the business tax (unless reinvested). *See* FLAT TAX I, *supra* note 11, at 63. In income tax terms, an expensed asset has a zero basis, so the entire amount realized on its sale is taxable gain.

amount he will be able to consume is $82.50. Using a 10% discount rate, the present value in the first year of $82.50 in the next year is $75. The result is that the combination of the 25% wage tax and the 40% business tax does *not* distort the consumption timing decision. Whether he consumes in the first year or the second year, the present value of the consumption will be $75.

The result in the example generalizes. The present value of the after-tax consumption will always be simply the amount of the wages, reduced by the effective wage tax rate in the year the wages were earned.[137] Since the present value of the consumption depends only on the wage tax burden in the year the wages were earned, it is unaffected by consumption timing. As a result, consumption timing neutrality will exist in this bifurcated tax system no matter what rate structure is chosen for the wage tax. What is crucial to consumption timing neutrality in this system is that the rate of the business tax be flat and constant over time.[138] As long as the business tax rate is flat and constant, the present value of consumption depends on the effective wage tax rate in the initial year, *and on nothing else*—not the structure of wage tax marginal rates (whether flat, progressive or regressive), not on the relationship between wage tax and business tax rates, and not on wage tax rates in later years.

Whatever the merits of the consumption timing neutrality argument for a flat cash-flow tax of the usual sort, the argument places no limits on the rate graduation of the wage tax portion of the Hall-Rabushka bifurcated tax.

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137 Suppose a taxpayer earns wages W. The amount he can invest in his business, after taking into account both the wage tax rate (wt) and the business tax rate (bt) is:

$$W\left(\frac{1-wt}{1-bt}\right).$$

This amount will grow at the annual rate of r, for the n years that the taxpayer postpones consumption. Thus in year n the investment will have grown to:

$$W\left(\frac{1-wt}{1-bt}\right)(1+r)^n .$$

If it is converted to consumption in year n, the amount available for consumption after imposition of the business tax will be:

$$W\left(\frac{1-wt}{1-bt}\right)(1+r)^n(1-bt) .$$

From the perspective of the first year (in which the wages were earned), the present value of that future consumption is:

$$\left(\frac{1}{(1+r)^n}\right)W\left(\frac{1-wt}{1-bt}\right)(1+r)^n(1-bt) .$$

Simplifying the expression, $(1+r)^n$ and $(1-bt)$ drop out, and the present value is just $W(1-wt)$. Obviously, this value is independent of n (i.e., the year in which consumption occurs).

138 Only if bt is flat and constant over time does $(1-bt)$ drop out of the present value formula. *See supra* note 137.

B. A Wage Tax and Neutrality among Earnings Patterns

1. The Case for the Link

One argument in favor of a consumption tax is based on the similarity between a consumption tax and a one-time tax on endowment. *Blueprints*, for example, suggests that "endowment"—defined as a person's wealth at the beginning of his working years, including the value of his human capital—is a good measure of lifetime ability to pay tax, and thus a theoretically attractive tax base.[139] Problems of valuation and liquidity make an endowment tax impractical, but a consumption tax more nearly approximates the effects of an endowment tax than does an income tax.

For ease of illustration, consider a situation in which the only wealth is human capital.[140] Imagine two persons with equal value human capital. Each wants to consume an equal amount in each year. Under an income tax they will bear different lifetime tax burdens despite their equal endowments, if they have different patterns of lifetime earnings.[141] Under a wage tax, however, two persons with equal human capital endowments will bear equal lifetime tax burdens regardless of the timing of their earnings, *if* the same tax rate applies to all earnings of each. Therefore, one who favors a wage tax out of a desire to impose equal tax on equal human capital endowments will want the tax to have a single rate, constant over time.

A simplified example illustrates the point. Taxpayers C and D begin their working years with no wealth except the present value of their future earnings. There are only two earnings periods—present period 1 and future period 2. C will earn $100,000 in period 1 and nothing in period 2; D will earn nothing in period 1 and $150,000 in period 2. The time value of money is such that $100,000 now and $150,000 in period 2 have equal present values. Thus C and D have human capital endowments of equal value. Will they face equal tax burdens under a wage tax? Yes, *if* the same tax rate applies to each. At a 20% rate, for example, C will have $80,000 after tax in period 1 and D will have $120,000 after tax in period 2. The pre-tax equality of the present value of their endowments is thus maintained post-tax.[142] If C and D both want

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139 BLUEPRINTS, *supra* note 105, at 36.

140 In this situation the major difference between a consumption tax and a wage tax disappears; the fact that a consumption tax burdens existing nonhuman capital, while a wage tax does not (*see supra* text accompanying notes 30-33), is irrelevant when there is no wealth other than human capital.

141 A taxpayer whose earnings are front-loaded will have to save to smooth his consumption, and that will subject him to the income tax's double tax on savings. *See* BLUEPRINTS, *supra* note 105, at 37-38. A taxpayer who earns the same amount each year will not have to save to smooth consumption, and so will avoid the double tax.

142 As the example illustrates, a flat rate wage tax will impose equal tax burdens on taxpayers who begin their working years with future earnings of equal present value, even

to smooth their consumption over the two periods, C will have to save and D will have to borrow. The saving and borrowing have no tax consequences under a wage tax, and so do not disrupt the equality between the two taxpayers.[143]

But what if the tax has graduated rates, so that C pays tax at an average rate of 20% on $100,000, and D pays at an average rate of 30% on $150,000? Then C's after-tax endowment is still $80,000, but D's is only $70,000 (the present value of period 2 after-tax earnings of $105,000). The general point is that if two taxpayers have equal-value endowments, but one has greater bunching of wages, a graduated rate wage tax will impose a heavier burden on the taxpayer with the bunching.[144]

2. Relating the Case to the Bifurcated Base of the Flat Tax

The essence of the above analysis is not changed by moving to a world with old capital, other than human capital, in existence at the time a new tax system is introduced, and by imposing the bifurcated base of the flat tax rather than simply a wage tax. If the business tax is imposed at the same rate as the wage tax, and if the rate of each tax remains fixed over time, the combined effect of the business and wage taxes will be to tax equal endowments equally—regardless of how those endowments are divided between human and other capital, and regardless of the timing of earnings from either form of capital.

This conclusion can be illustrated by modifying the above example, so that D has no human capital endowment, but is en-

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if their earnings patterns are different. However, economists commonly define a person's labor endowment as the present value of *potential* future earnings, were one to work the maximum possible number of hours. *See* FULLERTON & ROGERS, *supra* note 115, at 22-23. This definition includes the value of all time available to a person—whether devoted to paid labor, to unpaid labor, or to leisure, and values all that time at the person's wage rate. Under this definition of endowment, even a flat rate wage tax will not impose equal burdens on two persons with equal endowments, if one decides to devote more time to paid labor than the other, or if one chooses to work at his highest available wage rate and the other does not.

There is another, closely related, difference between a wage tax and an actual one-time tax on endowment. An actual endowment tax, as defined by Fullerton and Rogers, would involve no efficiency cost. It would not distort behavior, because it would not be based on behavior. *See id.* at 39. The wage tax, by contrast, imposes an efficiency cost because it distorts the choice between paid labor and untaxed uses of time.

143 Each will be able to consume $48,000 in each period. C has $80,000 after-tax in period 1. If he consumes $48,000 and saves $32,000, the savings will grow to $48,000 by period 2. D borrows and consumes $48,000 in period 1. In period 2 he earns $150,000. After paying $30,000 tax and $72,000 loan principal and interest, he can consume $48,000 in period 2.

144 *See* McCaffery, *supra* note 112, at 351. A taxpayer may have greater bunching of wages than another taxpayer with an equal-value endowment either because his earnings occur later in life, as in the example in the text, or simply because his earnings vary more from year to year.

dowed with other capital that will earn $150,000 in period 2. The endowments of C and D now differ both in nature (human capital for C, other capital for D) and in timing, but are still equal in present value. A 20% bifurcated wage-business tax will leave C with $80,000 after the wage tax in period 1, and D with $120,000 after the business tax in period 2, thus maintaining post-tax the equality of the present value of their endowments. The fact that the wage tax and the business tax share the same flat rate thus could be explained by a desire to impose equal tax burdens on endowments of equal value.

3. Some Objections

Imposing equal tax burdens on equal endowments is the strongest argument for a logical link between the Hall-Rabushka consumption tax base and a flat rate, but even this argument is subject to important objections. Three objections can be briefly noted before considering others in more detail. At the outset, the link is only as strong as the case for equal-tax-on-equal-endowments as a tax policy goal. *Blueprints* simply assumes the appropriateness of the goal,[145] without defending it. One who thinks ability to pay is better determined based on shorter periods than a lifetime will not be impressed with the goal.[146] Second, any tax imposed on actual earnings is a poor proxy for an endowment tax, if equal-endowment taxpayers make different choices about the extent to which they convert their earnings *potential* to *actual* earnings. The flat tax will impose a much heavier burden on the taxpayer who realizes his full earnings potential, than on an equally able taxpayer who works short hours at a low-paying, but pleasant, job.[147] This problem is sufficiently serious to call into question the entire project of trying to mimic the results of an endowment tax. Finally, the point about the implausibility of constant tax rates over time made earlier, with respect to the cash flow tax, applies here as well.[148] A policy goal whose accomplishment depends on Congress holding the tax rate steady over decades may not be worth pursuing.

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145 "*If* endowment is regarded as a good measure of ability to pay over a lifetime, this implies that *a consumption base is superior to an income base as a measure of lifetime ability to pay*." BLUEPRINTS, *supra* note 105, at 36 (first emphasis added, second emphasis in original).

146 "Ultimately, a lifetime view is not likely to hold much sway with legislators." GRAETZ, *supra* note 47, at 204.

147 *See* the discussion, *supra* note 142.

148 *See supra* text accompanying notes 124-26.

a. The inconsistency of Hall-Rabushka with the endowment tax rationale

Despite the fact that the endowment tax analysis supplies the strongest link between their chosen tax base and a flat rate, Hall and Rabushka do not rely on, or even mention, that analysis. That omission may be because the endowment tax rationale calls for a *truly* flat wage tax—i.e., a tax with no zero rate bracket created by exemptions. Consider how taxpayers C and D would fare under a 20% "flat tax" with a $30,000 exemption. The present value of C's after-tax wages would be $86,000.[149] The present value D's after-tax wages would be only $84,000.[150] D's average tax rate is higher than C's because of the exemption, and that difference destroys the equality of the tax burdens. In addition, the exemption means that an endowment consisting entirely of human capital is taxed less heavily than an equal-value endowment consisting entirely of other capital. Perhaps Hall and Rabushka realized that the wage tax exemptions in their proposal are inconsistent with the logic of the endowment tax analysis, and so they decided not to rely on that analysis.

Of course, one might believe that equal tax on equal endowments is a worthy goal, but also believe that exempting subsistence wages from tax is even more important. Then the flat tax might be attractive as imposing at least similar tax burdens on equal endowments, while also avoiding the taxation of subsistence earnings.

b. Balancing horizontal and vertical equity concerns

Equal tax burdens on those with equal endowments is purely a goal of horizontal equity; it says nothing about vertical equity—the relative tax burdens on those with greater and lesser endowments. Suppose a one-time tax on endowments were practical. Regardless of rate structure, the system would necessarily impose the same tax on all persons with the same endowment value, thus automatically achieving horizontal equity. If one's version of vertical equity were that those with larger endowments should be taxed at higher rates, a graduated rate structure could achieve that goal without compromising horizontal equity. There is no logical inconsistency in favoring both equity goals—equal tax on equal endowments in the name of horizontal equity, and progressive rates in the name of vertical equity. If a true endowment tax were feasible, then there would also be no technical inconsistency.

149 $100,000 wages (receivable immediately), less $14,000 tax (20% of $70,000 taxable wages).

150 The tax would be $24,000 (20% of $120,000 taxable wages). The after-tax wages of $126,000 would have a present value of $84,000.

In moving from a true endowment tax to a consumption tax substitute, however, a technical inconsistency emerges. The task for one who favors both goals is to find the best compromise between them. The question is whether graduated rates for the wage tax would do more good in terms of vertical equity than harm in terms of horizontal equity.[151] To a large extent, the answer depends on empirical information about the distribution of wages, among persons and over time.[152]

If everyone at any given level of lifetime labor endowment had the same lifetime earnings curve, there would be no horizontal equity objection to graduated rates. Each member of the group would bear the same lifetime tax burden regardless of the rate schedule. It is not necessary that the lifetime earnings curve for each member of the group be *flat* in order to obviate the horizontal equity objection to graduated rates; it is only necessary that the curve be *the same* for each member of the group.

It is easy, then, to state the two extreme cases. If there are no variations in earnings patterns *within* endowment levels, but there are large differences *between* endowment levels, rates should be graduated. On those facts, graduation would not interfere with horizontal equity, and would contribute significantly to vertical equity.[153] At the other extreme, if everyone has the same level of endowment, but the timing of earnings differs greatly among individuals, there should be a flat rate. On these facts, vertical equity would be a nonissue, and horizontal equity would require a flat rate. Which of these extremes is closer to the real world? As mentioned earlier, Fullerton and Rogers have documented the existence of large differences in the human capital en-

151 Graduated rates for the business tax are not possible under the Hall-Rabushka system, because the system makes no attempt to assign business income to particular business owners. FLAT TAX I, *supra* note 11, at 60-61.

152 A complete analysis would also require information about the distribution of other forms of capital. However, human capital tends to dwarf other forms of capital, even toward the high end of the endowment distribution. For example, David Bradford has calculated that "if a male with the 90th-percentile position in the discounted-income [i.e., human capital endowment] ranking received at age 40 the 90th-percentile inheritance, the effect would be to increase his lifetime wealth by about 4.2%; at the 95th-percentile position (by interpolation), 3.6%." BRADFORD I, *supra* note 35, at 173.

153 There is a qualification. It is theoretically possible that graduated rates could backfire in terms of vertical equity. Suppose there are just two endowment groups—high and low—and that they have very different lifetime earnings curves. Members of the high group earn $100,000 in period 1 and nothing in period 2. Members of the low group earn nothing in period 1 and $120,000 in period 2, which has a present value of $80,000 in period 1. With graduated rates, the low group may face a higher lifetime tax burden than the high group, which would be perverse. The chances of this being a serious problem in the real world are remote. As the example illustrates, the backfiring is likely to occur only if there are tremendous differences in the timing of earnings at different endowment levels. Although Fullerton and Rogers found that the earnings of different endowment groups do peak at different ages, the shapes of the curves are not so different as to make backfiring a major concern. FULLERTON & ROGERS, *supra* note 115, at 28 fig.1-3.

dowments of Americans.[154] To my knowledge there are no studies of differences in the timing of labor income *within* endowment levels.[155] It seems plausible, however, that differences in the timing of earnings within endowment levels are minor compared to differences in endowment levels. If that is true, then one who favors flat rates for horizontal equity and graduated rates for vertical equity, might well decide the vertical equity concern dominates—at least enough to justify moderate rate graduation. That decision would be reinforced by the possibility of lessening the impact of graduated rates on horizontal equity by wage averaging provisions.[156]

VII. CONCLUSION

A flat rate imposed on a bifurcated wage-business tax base is a defensible compromise among simplicity, efficiency, and fairness objectives in tax system design. There is nothing magic, however, about that particular compromise. Other than political expediency, there is no good reason for considering the base and the rate of the flat tax as a take-it-or-leave-it package. A single-minded concern for efficiency cannot justify the linkage of base and rate, because the flat tax does not remotely resemble the tax an efficiency purist would propose. Nor can an overriding desire for simplicity explain the base-rate connection. A version of the Hall-Rabushka model with a graduated wage tax would be nearly as simple as the flat tax, as would a version of the Hall-Rabushka model converted into a flat rate income tax. The argument for linking a consumption base and a flat rate in order to achieve tax neutrality between present and future consumption is problematic even for a standard cash flow tax, and the argument has no application to the bifurcated wage-business tax.

The endowment tax analysis is unique in suggesting a logical connection between the Hall-Rabushka base and a flat rate, but the connection will not persuade those who do not believe equal tax on equal endowments is an important and achievable policy goal. The most serious problem is that the logical connection addresses only horizontal equity, whereas tax system design must consider vertical equity as well. Those who favor graduated rates on vertical equity grounds are likely to find the horizontal equity case for a flat tax overwhelmed by the vertical equity case for graduated rates.

The terms of the tax reform debate should be changed. The issue should not be the merits of the flat tax. Instead, there

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154 *See supra* text accompanying note 115.

155 Fullerton and Rogers emphasize that their study does not consider differences within groups. FULLERTON & ROGERS, *supra* note 115, at 26-27.

156 *See supra* text accompanying note 123 (discussing consumption averaging and income averaging).

should be two debates—one on a consumption base versus an income base, and the other on a flat rate versus graduated rates. In the end, this separation of the issues is inevitable. The emphasis on flatness has worked well in attracting public attention to tax reform, but it would be naïve to suppose that the base issue can be kept hidden long enough for the flat tax to become law. If flat tax proponents are to succeed, they must eventually convince the public not only that flat is better than graduated, but also that a consumption base is better than an income base.

When public attention finally does focus on the base issue, the flat taxers may find that their political acumen in linking a consumption base to a flat rate is matched only by their folly in the choice of form for a consumption tax. With the high visibility of the wage portion of the tax, and the near invisibility of the business portion, the base can be easily portrayed by opponents as simply a wage tax. So portrayed, it is an easy target for populist complaints that a millionaire living off wealth (such as Steve Forbes himself) would pay no tax, while his chauffeur and his gardener would pay substantial tax.[157] In fact, owners of old capital would bear a substantial burden under the business tax, but it is probably impossible to convince the public of that reality.

For all their political savvy, the advocates of the flat tax may have made a crucial mistake in proposing a consumption tax in a form involving no personal tax on investment income. Although the USA Tax never caught on with the public because it lacked the attention-getting feature of a flat rate, the public is probably more open to an unlimited deduction for savings than to an exemption for investment income. Not taxing investment income sounds like an undeserved windfall for the idle rich, but an unlimited deduction for savings sounds like a just reward for the thrifty middle class.[158] The most saleable proposal for fundamental tax reform may be a flat version of the USA Tax, but it has yet to find a champion.

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157 *See* Ernest S. Christian, *How Much Simplification Is Enough? Is a Returnless Tax Realistic?* 73 TAX NOTES 1481, 1491 (1996) (citing example of a Rockefeller and his gardener); Bob Minzesheimer, *Key for Forbes Plan is Outsider Status*, USA TODAY, Feb. 5, 1996, at A6 ("Forbes' plan means a millionaire who lives off dividends and interest pays less tax than his chauffeur."); Patrick J. Buchanan, *A Flawed Flat Tax and the Way Out*, N.Y. TIMES, Jan. 17, 1996, at A19 (Bill Gates would pay no tax following an early retirement, but Microsoft employees would pay tax.). Slemrod and Bakija speculate that the flat tax will "fail a simple 'sniff test' of Americans accustomed to a personal tax on all income, who will find that a tax that *appears* to be on labor income only just doesn't smell right." SLEMROD & BAKIJA, *supra* note 7, at 250 (emphasis added).

158 "While the Armey Flat Tax gives providers of labor less power to choose [how much tax they pay] than the current system, the Nunn-Domenici Tax gives them more." Alice G. Abreu, *Untangling Tax Reform: Simple Taxes, Complex Choices*, 33 SAN DIEGO L. REV. 1355, 1416 (1996). If taxpayers prefer feeling empowered to feeling trapped, they will prefer a cash flow tax to a wage tax.